

## THE MANAGER

## PROFIT MANAGEMENT

By Jason Karszes &amp; Betsey Howland

By building working capital, you can help to shield your dairy from the difficulties that come with milk price variability

# Prepare for the next milk price downturn

**Given milk price variability** over the last 20 years, how dairies manage cash during both high and low earning years is critical to their success. Specifically, management must focus on what to do with positive earnings during good years to help position a business for the next down cycle.

Business liquidity is more important than ever. It's a dairy's ability to meet short-term cash commitments, usually over the next 12 months. With strong liquidity, a dairy is better able to meet those commitments during times of decreased or negative earnings.

Working capital, a key measure of liquidity, is defined as current assets minus current liabilities. Current assets are cash or cash equivalents, as well as assets normally converted to cash during the next 12 months. For dairy farms the major current assets are cash and savings, accounts receivable, and inventories of purchased supplies and grown feed.

Current liabilities are debts expected to be paid back in the next 12 months. These include accounts payable, operating loans, the current portion due on intermediate and long-term loans, and any planned lease payments on assets.

## Build working capital

You can build working capital by impacting different current asset and liability categories. This article looks at seven places on both sides of the balance sheet where you can "park" extra earnings. For help in your decision making, we list the pros and cons of each.

There may be tax implications when you build working capital depending on where you place the extra earnings. Consult your tax preparer.

## Asset side

### 1. Cash and Savings

Extra earnings, or excess cash income, are placed into cash and savings accounts. Though the funds could be invested elsewhere, it's advisable to have them available for operating needs, not generally invested for the long term.

Building up the cash and savings accounts improves working capital. And in the next down cycle, you can use pull cash reserves down to meet cash commitments.

## PRO and CON

- Most flexible. Funds are available for any use.
- Fiscal responsibility required. You can't just spend because you have money available.
- Low interest income. And you may be paying a higher interest rate on borrowed funds.

## 2. Accounts Receivable

You can delay payments for items sold during the year and build accounts receivable. For example, you might defer milk checks and increase the current assets portion of the balance sheet. Over the following year, these accounts receivable are converted to cash to meet cash commitments, if needed.

## PRO and CON

- Not readily available. You must wait until funds are received before you can spend them, so timing could be an issue. Once you have funds, it's no different than cash on hand.
- Limited risk. If the company that owes you money runs into financial difficulty, you may not receive the total amount due.
- Tax implications. If you pay taxes on a cash basis, you have moved income from one year to the next based on when the cash was received.

## FYI

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### 3. Purchased Supplies and Inventories

Purchasing additional supplies with extra earnings allows you to build your inventory during the good years and draw it down instead of paying that expense during the next year. This frees up cash for other purposes.

#### PRO and CON

- Less flexibility. Once supplies are purchased, they generally can't be resold.
- Limited risk. If purchased supplies aren't taken in delivery at time of purchase, you have a limited risk associated with being an unsecured lender with the supplier.
- Inventory tied up. And it's not generating any earnings. This is part of the carrying costs associated with inventory.
- Tax implications. If you pay taxes on a cash basis, you've increased taxable expense for the current year, impacting both the current and following years.
- Shrink or loss. This is also part of carrying costs.

### 4. Grown Feed Inventories

By growing more crops, harvesting a greater percentage of crops grown or capturing a good growing year, you build forage inventory and also increase working capital. With a larger grown-feed inventory, you have more flexibility in terms of what crops to grow, harvest, keep or sell in the future.

#### PRO and CON

- Less flexible. If you're feeding out the crops grown, you can't convert that to cash until fed and output is sold. If you're selling extra forage, there's no cash on hand until the sale.
- Price risk. What is the inventory actually worth when it's sold?
- Storage losses. How much is harvested vs. what is sold?
- Carrying costs. How much capital is tied up for how long?
- Tax implications. The product isn't taxable revenue until it's sold if you file on a cash-basis, impacting current and next year.

#### Liability side

##### 1. Accounts payable

This is any money owed for supplies or services that you've received or used. For example, a feed bill just received for feed delivered two weeks ago is an account payable even though payment may not be due for two more weeks.

By decreasing the amount of accounts payable owed by the end of the year, you decrease the amount due in the next year.

#### PRO and CON

- Less flexible. Once a bill is paid, you can't get the cash back.
- Short term. You're usually talking about one to three months of bills at the most.
- Minimal risk. You're not investing in any other business.
- Limited use. Once all bills are current to delivery date, accounts payable are at zero. If you pay more, you're technically buying inventory ahead.
- Tax implications. Possible increased taxable expense, impacting the current and future tax calculations.

##### 2. Operating Debt

By decreasing the amount of operating debt, or that debt expected to be paid back in 12 months or less, there are fewer funds needed to service total debt.

#### PRO and CON

- Flexibility. If your operating loan is approved or renewed, you can borrow funds when needed.
- Tax implications. Earnings used to pay down an operating loan are treated as taxable income.
- Minimize interest expense. This occurs when you lower total principal outstanding.

### 3. Lowering Principal Due

The current liability on loans longer than one year is determined by the length, interest rate and outstanding principal. If you lower the outstanding principal and recalculate the payment based on the original length of the loan, you decrease the amount of the minimum monthly payment. Plus, you'll need less cash in the next 12 months to service the planned debt payments. To a lesser extent, a lower principal may mean lower interest costs.

#### PRO and CON

- Lender's role. You must work with your lender to get minimum payments reduced if you use extra earnings to reduce principal.
- Variable impact. You only increase working capital by the amount the minimum monthly payment is reduced.
- Tax implications. Earnings used to pay extra principal are taxable, impacting the current year tax calculations.

A dairy manager can build working capital through many different uses of earnings generated in good years. While any of the approaches presented here can improve a business' ability to meet cash commitments over the short term, individual business and family goals will influence which approaches you use. □

## Measures of working capital

### Current Ratio

**Defined:** Total current assets divided by total current liabilities.

**Question:** If you sold all current assets, would current liabilities be covered?

Weak	Stable	Strong
<1.50	1.50 – 2.00	> 2.00

### Working Capital

**Defined:** Total current assets minus total current liabilities.

**Questions:** What operating capital is available within your business? In which direction is the amount going over time?

Weak	Stable	Strong
Negative Trend	Staying the Same	Positive Trend

### Working Capital to Gross Expenses

**Defined:** Working capital divided by total expenses.

**Question:** What percent of the farm expenses is available as excess operating capital?

Weak	Stable	Strong
<14%	14% – 20%	> 20%